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Managing Director & Principal

March 29, 2011

Dr. George Diehr
Chair, Investment Committee
California Public Employees' Retirement System
400 Q Street
Sacramento, CA 95814

Re: Asset Allocation for JRS and LRS

Dear Dr. Diehr:

You have requested our thoughts regarding the proposed new asset allocation mixes for the Judges' Retirement System II and the Legislators' Retirement System as presented by Staff.

Recommendation

We agree with Staff's recommendations regarding the new asset allocation mixes for JRS II (P7) and LRS (P2).

Discussion

Given the relatively young population of the JRS II pool (2% retired) and the current funded status (77%), it appears that taking on slightly more risk in exchange for more return opportunity, especially in a better-diversified portfolio with five asset classes is appropriate. As a result, we believe that both alternative mixes P6 and P7 are superior choices for this portfolio relative to the current asset allocation mix, from purely an asset point of view. Once the calculations by CalPERS' actuaries are considered, as well as the new asset allocation adopted for the PERF (which has a larger retired population than JRS II), we agree that the riskier and higher-returning portfolio P7 is appropriate for this pool of assets.

LRS is a substantially different portfolio the JRS II, with almost 90% of the population retired and a funded ratio above 100%. These facts alone would argue for a significantly more conservative portfolio than either the PERF or JRS II. Staff's proposal of P2, which has a higher return, lower risk, higher Sharpe ratio, better diversification, and lower potential loss rate and worst case loss versus the current portfolio seems mathematically superior by all metrics. The recommendation of P2 is also consistent with the asset allocation mixes selected in 2000 and 2004 that have slowly decreased the risk and equity exposure in the portfolio as the population has aged.

Please let us know if you have any questions or comments.

Best regards,